Principles of Accounting and Financial Reporting: A Case Study Compilation

Olivia Duke
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Principles of Accounting and Financial Reporting: A Case Study Compilation

By

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A thesis submitted to the faculty of the University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College

Oxford
May 2020

Approved by

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ACKNOWLEDGEMENTS

First and foremost, thank you so much to my incredible family for supporting me in each and every one of my endeavors, academic and otherwise. I would not be where I am today without their steadfast encouragement. To my wonderful friends, thank you for being such a strong support system in times both good and bad throughout my entire college career. To each and every one of my teachers, from kindergarten, to The Oakridge School, all the way through the Sally McDonnell Barksdale Honors College and the Patterson School of Accountancy, thank you for instilling in me a love of learning and a desire to push myself to be better every day. Lastly, to the University of Mississippi, thank you for being my home away from home and for providing me with all the tools I will need for happiness and success in the future.
ABSTRACT
OLIVIA MARGARET DUKE: Principles of Accounting and Financial Reporting: A Case Study Compilation
(Under the Direction of Dr. Victoria Dickinson)

The following case studies are a demonstration of knowledge regarding proper accounting procedures in accordance with Generally Accepted Accounting Principles (GAAP) as set by the Financial Accounting Standards Board (FASB). This thesis examines the various treatments of different areas of accounting as well as how a good accountant should carry himself or herself in the professional environment. Each case study presents a different set of solutions regarding various concepts crucial to the understanding of accounting as a subject that with which professionals should be familiar upon entering the workplace. The case studies were completed under the direction of Dr. Victoria Dickinson in fulfillment of the requirements for the University of Mississippi, Sally McDonnell Barksdale Honors College, and Patterson School of Accountancy ACCY 420 course in the 2018-2019 academic year.
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Case Study #1: IDEA Software

Olivia Duke

Dr. Dickinson

5 September 2018
Executive Summary – IDEA Software

IDEA is a data analytics software that is gaining popularity in the field of accounting. Its main function is to intake large volumes of data and generate helpful visualizations as well as important figures and statistics. IDEA, therefore, is primarily an auditing software because it can list every transaction in which a company takes part in any given period, whether that be a month, a year, or a comparison between multiple years. It is very difficult to commit fraud when every single transaction is listed in one place, which is unique to IDEA software. However, IDEA has some functions that can be used in tax practices as well. The ability to hold so much data in one singular location allows accountants to not only compare data within companies, but also between companies. This is beneficial to tax accountants searching for the best way to plan a merger or an acquisition. IDEA takes data from nearly any source and keeps it in one, simple place.

The field of data analytics within the profession of accounting is growing rapidly. There are so many different types of software that have varying functions and degrees of utility. There is a huge demand for accountants who have a mastery in these types of software. This can seem daunting because there is a chance that software will soon come to replace accountants, but this has not been the case since the expansion of data analytics into accounting. These programs streamline efficiency and effectiveness, but do not cut out the need for actual workers. The combination of software like IDEA and in person accountants is creating an entirely new approach to the profession of accounting, both in audit and in tax. It is imperative that today’s accountants have a basic knowledge of major data analytic software in order to remain at the forefront of the field of accounting through research and technology.
1. Identify the purpose of this tool and describe, in general, how it is used to make business decisions.

IDEA is a software designed to intake large sets of data at once and display it in an easy-to-read and user-friendly format. Standard software like Microsoft Excel is not designed to record sets of data that have between thousands and millions of points. An example of this type of data would be the total transactions a company has within a fiscal year. IDEA’s visualization tool allows accountants and their clients to see all the data fed into the program formatted into graphs, charts, and other informative graphics. When a company needs to look at all the information in its entire system, it is difficult to make decisions due to the sheer amount of data laid out. There would be too much information to comprehend at one time. IDEA solves this predicament by computing and condensing mass amounts of data into the key points that decision makers need to know in order to make decisions.

2. How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.

a. Audit

i. One scenario in which IDEA would be useful in an audit situation is rooting out discrepancies between various financial statements, or any fraud schemes a client could be planning. For example, IDEA has a feature that matches inventory records to payments, which protects not only the exchange of goods for actual purchases on invoices and the
making of false invoices for goods not sold. IDEA can hold every transaction a company makes, and therefore is able to detect fraud, either accidental or on purpose, and prevent it from happening.

ii. An auditor’s main job is to create financial statements so that their clients are able to make reasonably informed decisions regarding their business or investments. Since IDEA has the ability to generate the ending totals of financial statements, such as net income for income statements or total assets, liabilities, and owner’s equity or capital for balance sheets, accountants now have a secure way to double check their own work to ensure calculations are correct. In addition, if an auditor is in a meeting with a client and does not have her own files on hand, but does have her computer with IDEA loaded on it, she is able to inform her client on the information that is listed on financial statements.

iii. Not only can IDEA hold all types of data necessary for the current fiscal year, it also still has room to hold data for past years as well. Once again using IDEA’s visualization option, it is possible to view changes from year to year with ease on one, singular interface. Clients need to see trends ranging between months, quarters, and even years. IDEA allows quick comparison without difficulty, as it holds copious amounts of data that can generate financial statements and important balances for many years at once.
b. Tax

i. Although an auditing software, IDEA still has major benefits when it comes to tax planning. For example, it is possible to input all necessary data for not just one, but multiple companies and project what possible benefits and additional costs would come from a merger or acquisition. IDEA can also be used to make different combinations of two companies’ incomes and other revenues to best determine how to plan their taxes in the event of a merger or acquisition.

ii. In addition to holding all financial information necessary to audits, IDEA can facilitate the understanding of new tax reforms as they go into law. By inputting the tax laws as they change, tax accountants can see what parts of a client’s income is taxed differently and strategize different ways for that client to pay the minimum legal amount on the data already fed into the IDEA system.

iii. Accounting is so consistent in the business world because its firms add value to the clients for whom they work. Tax accountants analyze financial statements in order to find the legal way for clients to pay the least amount possible. IDEA can compare the what the baseline would have been and the benefits of the value added by accountants for finding that legal minimum of taxes to be paid. The value added by tax accountants saves a lot of money for clients’ companies, and IDEA can give a visual to clients of that value added.
MEMO

To: Audit and Tax Partners

From: Olivia Duke

Date: 5 September 2018

Re: Implementation of IDEA Software

IDEA is an ideal tool to have in our accounting arsenal. While basic software like Microsoft Excel is useful for everyday tasks, if we hope to retain large companies as clients, a much larger and stronger database is necessary. The great thing about IDEA is that while it holds more data than is almost fathomable, it also has panels of graphs and charts that make it much easier to analyze and interpret the data provided by any given client or clients.

In addition to the necessity of IDEA’s functionality, user reviews have been very impressed with the simplicity of the software. CaseWare Analytics provides instructions and tutorial videos that are easy to follow. The user testimonies are all positive and report a simple interface that is mastered easily with the instruction provided by the creator, CaseWare Analytics. The cost of training our staff in IDEA software would be at a low cost and at a high benefit, as it would appeal to our clients that are large companies and begin to attract even larger companies than the ones we already have, given that our employees would now have a mastery of a software designed to hold extreme volumes of data.
The integration of IDEA into our firm would be beneficial because it can streamline efficiency and effectiveness. Handling data sets with thousands, even millions, of points can become quite tedious and repetitive. IDEA, although primarily an audit software, can be employed by both audit and tax practices to improve methods of computation and analysis on the data presented to us by our clients.
Works Cited


IDEA.

IDEA Software | IDEA Data Analysis.” CaseWare Analytics,


International, CaseWare. “IDEA.” Reviews and Pricing - 2018,

www.capterra.com/p/129838/IDEA/#reviews.
Case Study #2: Rocky Mountain Chocolate Factory

Olivia Duke
Dr. Dickinson
12 September 2018
Executive Summary – Rocky Mountain Chocolate Factory

Rocky Mountain Chocolate Factory is a major chocolate manufacturer, with production facilities in the United States, Canada, and United Arab Emirates. Their financial statements are extremely important because creditors, lenders, and investors are in need of correct information in order to make decisions for the present and future. Throughout this case study, the important skills that I learned were the steps of completing financial statements form journalizing transactions all the way to closing entries, as well as the maneuvering of Microsoft Excel in the field of accounting. Using Excel to create financial statements beginning from journal entries is beneficial because the only errors are those from users entering data incorrectly or typing the wrong key; there are no computational errors. Technology is complementary to accountants, not supplementary, and using Excel to generate financial statements is a perfect example of this.
a. Prior to examining the company’s actual balance sheet, read the description of Rocky Mountain Chocolate Factory, above. What accounts do you expect to see on the balance sheet? Which accounts constitute the major assets? Which accounts constitute the major liabilities?

As a for profit manufacturing company, I would expect to see cash as the largest asset on the balance sheet. Their main line of income is sales from chocolate as well as franchise fees, which would bring in cash as well as increase accounts payable. As a creator of chocolate, Rocky Mountain Chocolate Factory would also have very large amounts in the equipment and inventory accounts. As for liabilities, I would expect to see the largest amounts in accounts payable and other payable accounts like salaries and wages or interest, because a company the size of Rocky Mountain Chocolate Factory is more likely to defer expenses and initially put them in a payable account rather than pay in cash.

e. Based on the transactions you recorded in parts b and c, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.

I would expect to see adjustments made for depreciation on equipment, since that is a major asset for Rocky Mountain Chocolate Factory. This would be a debit to depreciation expense and a credit to net PPE. I would also expect to see an adjustment for wages and salaries expenses, because the fiscal period rarely lines up perfectly with the payment schedule and these types of adjusting entries are very common. This entry would be a debit to wages and salaries expense and a credit to wages and salaries
payable. In addition, the financial statements must recognize the inventory sold over the period along with its cost by debiting cost of goods sold and crediting inventory.
| Cash and Cash Equivalents | 1,253,947 | 17,000,000 | -8,200,000 | 4,100,000 | -2,000,000 | -6,423,789 | 125,000 | -498,832 | -2,403,458 | 790,224 | 3,743,092 | 3,743,092 | 3,743,092 |
| Accounts Receivable | 4,229,733 | 5,000,000 | -4,100,000 | (702,207) | 4,427,526 | 4,427,526 | 4,427,526 | 4,427,526 | 4,427,526 | 4,427,526 |
| Notes Receivable, Current | - | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 | 91,059 |
| Inventories | 4,064,611 | 7,500,000 | 6,000,000 | -14,000,000 | (66,328) | 3,498,283 | -216,856 | 3,281,447 | 3,281,447 | 3,281,447 |
| Deferred Income Taxes | 369,197 | 92,052 | 461,249 | 461,249 | 461,249 | 461,249 | 461,249 |
| Property and Equipment, Net | 5,235,594 | 498,832 | 132,859 | 5,885,289 | -698,580 | 5,186,709 | 5,186,709 | 5,186,709 | 5,186,709 | 5,186,709 |
| Notes Receivable, Less Current Portion | 124,452 | 139,198 | 263,650 | 263,650 | 263,650 | 263,650 | 263,650 |
| Goodwill, Net | 1,046,944 | 1,046,944 | 1,046,944 | 1,046,944 | 1,046,944 | 1,046,944 |
| Intangible Assets Net | 103,135 | (73,110) | 110,025 | 110,025 | 110,025 | 110,025 | 110,025 |
| Other | 91,057 | (3,007) | 88,050 | 88,050 | 88,050 | 88,050 | 88,050 |
| Accounts Payable | (1,074,641) | -7,500,000 | -6,000,000 | (466,156) | 466,156 | 466,156 |
| Accrued Salaries and Wages | 453,789 | 642,378 | 642,378 | (877,832) | 877,832 | 877,832 |
| Other Accrued Expenses | (531,941) | -3,300,000 | 2,885,413 | (946,528) | (946,528) | 946,528 | 946,528 |
| Dividend Payable | (598,986) | -3,709 | (602,694) | (602,694) | (602,694) | 602,694 | 602,694 |
| Deferred Income | (142,000) | -125,000 | 46,062 | (220,938) | (220,938) | (220,938) | (220,938) |
| Deferred Income Taxes | (827,700) | -66,729 | (894,429) | (894,429) | (894,429) | (894,429) | (894,429) |
| Common Stock | (179,696) | (1,112) | (180,808) | (180,808) | (180,808) | (180,808) | (180,808) |
| Additional Paid-In-Capital | (7,311,280) | (315,322) | (7,626,602) | (7,626,602) | (7,626,602) | (7,626,602) | (7,626,602) |
| Retained Earnings | (5,751,017) | 2,407,167 | (3,343,850) | (3,343,850) | (3,343,850) | (3,343,850) | (3,343,850) |
| Sales | - | -22,000,000 | (944,017) | (22,844,017) | (22,844,017) | (22,844,017) | (22,844,017) |
| Franchise and Royalty Fees | - | (5,492,531) | (5,492,531) | (5,492,531) | (5,492,531) | (5,492,531) | (5,492,531) |
| Cost of Sales | - | 14,000,000 | 69,786 | 14,693,786 | 216,816 | 14,916,622 | 14,916,622 |
| Franchise Costs | - | 1,499,477 | 1,499,477 | 1,499,477 | 1,499,477 | 1,499,477 | 1,499,477 |
| Sales & Marketing | 1,505,431 | 1,505,431 | (1,505,431) | (1,505,431) | (1,505,431) | (1,505,431) | (1,505,431) |
| General and Administrative | 2,044,509 | 1,782,847 | 639,200 | 2,422,147 | 2,422,147 | 2,422,147 | 2,422,147 |
| Retail Operating | - | 1,750,000 | 1,750,000 | 1,750,000 | 1,750,000 | 1,750,000 | 1,750,000 |
| Depreciation and Amortization | - | 698,580 | 698,580 | 698,580 | 698,580 | 698,580 | 698,580 |
| Interest Income | - | (27,210) | (27,210) | (27,210) | (27,210) | (27,210) | (27,210) |
| Income Tax Expense | - | 2,090,468 | 2,090,468 | 2,090,468 | 2,090,468 | 2,090,468 | 2,090,468 |

A = L - O + R - E
Rocky Mountain Chocolate Factory  
Income Statement  
For Year Ending 2/28/2010

<table>
<thead>
<tr>
<th><strong>Revenue</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>22,944,017.00</td>
</tr>
<tr>
<td>Franchise and Royalty Fee</td>
<td>5,492,531.00</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td><strong>28,436,548.00</strong></td>
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<table>
<thead>
<tr>
<th><strong>Costs and Expenses</strong></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Sales</td>
<td>14,910,622.00</td>
</tr>
<tr>
<td>Franchise costs</td>
<td>1,499,477.00</td>
</tr>
<tr>
<td>Sales and Marketing</td>
<td>1,505,431.00</td>
</tr>
<tr>
<td>General and Administrative</td>
<td>2,422,147.00</td>
</tr>
<tr>
<td>Retail Operating</td>
<td>1,756,956.00</td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>698,580.00</td>
</tr>
<tr>
<td><strong>Total Costs and Expenses</strong></td>
<td><strong>22,793,213.00</strong></td>
</tr>
<tr>
<td><strong>Operating Income</strong></td>
<td>5,643,335.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Other Income (Expense)</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Other Income (Revenue)</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Income</td>
<td>27,210.00</td>
</tr>
<tr>
<td><strong>Income Before Tax</strong></td>
<td><strong>5,670,545.00</strong></td>
</tr>
<tr>
<td><strong>Income Tax Expense</strong></td>
<td><strong>2,090,468.00</strong></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>3,580,077.00</strong></td>
</tr>
<tr>
<td><strong>EPS</strong></td>
<td><strong>0.59</strong></td>
</tr>
</tbody>
</table>
# Rocky Mountain Chocolate Factory
## Balance Sheet
### As Of 2/28/2010

### Assets

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and Cash Equivalents</td>
<td>3,743,092.00</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>4,427,526.00</td>
</tr>
<tr>
<td>Notes Receivable, Current</td>
<td>91,059.00</td>
</tr>
<tr>
<td>Inventories</td>
<td>3,281,447.00</td>
</tr>
<tr>
<td>Deferred Income Taxes</td>
<td>461,249.00</td>
</tr>
<tr>
<td>Other</td>
<td>220,163.00</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>12,224,536.00</td>
</tr>
<tr>
<td><strong>Property and Equipment, Net</strong></td>
<td>5,186,709.00</td>
</tr>
<tr>
<td><strong>Other Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Notes Receivable, Less Current Portion</td>
<td>263,650.00</td>
</tr>
<tr>
<td>Goodwill, Net</td>
<td>1,046,944.00</td>
</tr>
<tr>
<td>Intangible Assets, Net</td>
<td>110,025.00</td>
</tr>
<tr>
<td>Other</td>
<td>88,050.00</td>
</tr>
<tr>
<td><strong>Total Other Assets</strong></td>
<td>1,508,669.00</td>
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<tr>
<td><strong>Total Assets</strong></td>
<td>18,919,914.00</td>
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</table>

### Liabilities and Stockholders' Equity

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>877,832.00</td>
</tr>
<tr>
<td>Accrued Salaries and Wages</td>
<td>646,156.00</td>
</tr>
<tr>
<td>Other Accrued Expenses</td>
<td>946,528.00</td>
</tr>
<tr>
<td>Dividend Payable</td>
<td>602,694.00</td>
</tr>
<tr>
<td>Deferred Income</td>
<td>220,938.00</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>3,294,148.00</td>
</tr>
<tr>
<td>Deferred Income Tax</td>
<td>894,429.00</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>4,188,577.00</td>
</tr>
<tr>
<td><strong>Stockholders' Equity</strong></td>
<td></td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>-</td>
</tr>
<tr>
<td>Junior Stock</td>
<td>-</td>
</tr>
<tr>
<td>Undesignated Stock</td>
<td>-</td>
</tr>
<tr>
<td>Common Stock</td>
<td>180,808.00</td>
</tr>
<tr>
<td>Additional Paid in Capital</td>
<td>7,626,602.00</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>6,923,927.00</td>
</tr>
<tr>
<td><strong>Total Stockholders’ Equity</strong></td>
<td>14,731,337.00</td>
</tr>
<tr>
<td><strong>Total Liabilities and Stockholders' Equity</strong></td>
<td>18,919,914.00</td>
</tr>
<tr>
<td><strong>Transaction</strong></td>
<td><strong>Cash Flow Section</strong></td>
</tr>
<tr>
<td>------------------------------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>1. Purchase Inventory</td>
<td>operating</td>
</tr>
<tr>
<td>2. Incur Factory Wage</td>
<td>operating</td>
</tr>
<tr>
<td>3. Sell inventory for cash and on account</td>
<td>operating</td>
</tr>
<tr>
<td>4. Pay for inventory</td>
<td>operating</td>
</tr>
<tr>
<td>5. Collect receivables</td>
<td>operating</td>
</tr>
<tr>
<td>6. Incur SG&amp;A (cash and payable)</td>
<td>operating</td>
</tr>
<tr>
<td>7. Pay wages</td>
<td>operating</td>
</tr>
<tr>
<td>8. Receive franchise fee</td>
<td>operating</td>
</tr>
<tr>
<td>9. Purchase PPE</td>
<td>investing</td>
</tr>
<tr>
<td>10. Dividends declared and paid</td>
<td>financing</td>
</tr>
</tbody>
</table>
Case Study #3: Consistency with Transparency and Performance

Olivia Duke
Dr. Dickinson
19 September 2018
Executive Summary – Transparency and Performance

Accounting is quite a popular major for college students, especially at the University of Mississippi because of its renowned Patterson School of Accountancy. This degree plan offers many different career options, not only in the world of public accounting but also anywhere else in law, business, or consulting. In a debate during a class meeting for accounting students in the Sally McDonnell Barksdale Honors College at the University of Mississippi, many different aspects of the accounting degree were discussed, such as graduate degree plans, career fields, and how to approach asking employers for transfers. Talking about these dilemmas in an undergraduate setting was very beneficial because it allowed us to think about how we might handle those situations ourselves well before they actually arise.
Scenario #1

The first scenario, presented in the form of a conversation, was two students discussing whether it would be more beneficial to pursue a master’s degree in taxation or to go to law school to become a tax attorney upon receiving a bachelor’s degree in accounting. The student wanting to obtain a JD pointed out that tax attorneys have a much larger starting salary, and do the same type of work as tax accountants. However, there are also drawbacks to law school instead of the master’s degree program, especially the master’s program at University of Mississippi. Law school requires three years of post-graduate education, while Patterson’s master’s program is one year. In other words, law students spend two more years in school paying two more years of tuition, and although they do have a higher starting salary, those students who earned their master’s degree will have already worked hard enough to raise their salaries to that of a tax attorney’s. In addition, a student who plans to go into law school and then work at a law firm afterwards would be taking the spot of a student whose end goal is to go into public accounting. If an undergraduate student in the Patterson School of Accountancy were to go through the recruiting process and accept a public accounting internship, knowing all the while that he or she would not be accepting a full time offer, that would reflect poorly back on the university because its students are not committing. The ideal compromise for me would be for that student to get an undergraduate degree in accounting, do their internship at a law firm during the typical time period of senior spring, and then go onto law school and become a tax attorney. Although law internships are not as common as those in public accounting for undergraduate students, I believe if a student consistently displays high performance, he or she would be able to obtain an internship in whichever field he or she desires, whether it be law, accounting, or any other type of field. If a law internship were impossible to obtain, the student
could consider accounting internships, but I would hope that would be as a back-up option so as not to be detrimental to anyone else. This path would allow the student to reap all the benefits Patterson has to offer without harming a fellow student’s chances or the reputation of our school.

Scenario #2

The second scenario was a conversation between three students about the different career paths one could take upon graduation, as opposed to educational paths discussed in the first scenario. Two choices brought forward were consulting and investment banking, both of which require a strong knowledge of accounting in order to be successful. Two of the students wanted to complete an internship in a public accounting firm, work a few years at that firm after graduation, and then move on to different fields in the business environment. Wanting to move on in such a manner is very common, and most students do not see themselves as public accountants in the long term. As someone who does see herself as a public accountant in the long term, this was a difficult scenario to process because I think it is very important to follow through on commitments until the end. Although these students would be following through contractually, it actually takes around three years for firms to gain back the money they invested in each intern hired. In addition to that, so much more time and so many more resources have been invested in these new employees since their hiring because it is important to stay up to date on policy and principles as well as continue to broaden and strengthen skills. Accounting is a very broad degree and is known as the language of business, but it seems illegitimate to me to take a position and allow money, time, and resources to be poured into you only to leave at the earliest possible chance. While the Patterson School of Accountancy is a great stepping stone, it should not be taken advantage of. It remains true that there is a “middle age mass exodus” from public accounting firms as consultants, bankers, and other businesses poach employees away, but
that should happen naturally and not as soon as possible. Patterson is such a great program, and it is possible to network and form connections with future employers as a junior, or even as a sophomore. The best option for these students is to double major in accounting and finance, or accounting and business, so that they can gain education in their intended fields as well. These students could take an internship if they really felt it was the best choice for them, but I would not want them to accept a position with the firm after graduation if they intend to leave after only one or two years. Accounting is a very portable degree, in the words of Dr. Vicki Dickinson, especially from the University of Mississippi, and adding onto that with a double major in your desired career area will be very attractive to potential employers while maintaining the relationships Patterson has with the Big 4 and many other public accounting firms, allowing future students to reap the same benefits for years to come.

**Scenario #3**

The last scenario was different than the others because it involved how to handle a situation after an internship but before obtaining a master’s degree, instead of potential problems that may or may not change throughout the rest of undergraduate years or an internship. A student had completed a Big 4 internship in Washington, D.C., and decided that location was not the right place for him. He wanted to return home to Dallas, hopefully with that firm, but would still be going home even if the firm pulled his offer. There were no reasons offered except the fact that Dallas was his hometown and that was where he needed to go. It is important to consider other things that may be going on in his personal life, such as a sick family member or perhaps he did not fit well with the people in the DC office, but that is not the main question in this scenario. The question is whether or not he should be going home in the first place. Should he try to bear down in Washington and hopefully be transferred after putting in his time, or
should he give up and go home either way? Dallas of all cities is a major accounting hub and is a very attractive location for interns. Allowing this student to transfer to the Dallas office immediately after earning his master’s degree would mean one of the students who had done their internship in Dallas would have to go to another location, as there is only room for a certain number of freshly graduated hires in each office. That is certainly unfair to whoever would be sent to another location. While it is understandable that this student would want to return home, the years immediately after graduation are a time to find your place in the world, as well as put in the time to prove your worth to your employer. If this student were to ask to be moved from DC to Dallas after having only done an internship in DC, that office would not see if he was a high performer or not, and may tell him no. If they did allow him to move to Dallas, the DC office would lose a substantial amount of money and resources they had invested into that employee. However, since the student has his heart set on returning home, he needs to be honest and transparent with his employers and explain his situation. If he tried to shy away from the situation and handle it passively, it would reflect negatively on him and would not go in his favor. Dallas is his hometown, and most employers are willing to help because they want happy employees. With honesty and transparency, the transfer may go through. That being said, if I myself were in the situation, I would try to stay in Washington until I had shown my performance level and dedication to the company. By doing that, the firm would be more willing to make a transfer happen smoothly and thereby making both themselves and me a more satisfied employer and employee.

Through all these scenarios, the theme that has prevailed is that of transparency, consistency, and high performance. The first two scenarios, which involve getting an education in accounting from the University of Mississippi but pursuing other career paths, require
transparency and high performance during the internship period. By being straightforward and
telling employers of their intentions, students can create relationships in the accounting world
and their employers can help them network into their desired fields of business, if they perform
highly. Firms want employees who want to be there, and can help bridge the transition into other
companies for employees who decide public accounting is not their long-term plan. In the case of
transferring offices between an internship and graduation, transparency from the start is the only
way to execute the change successfully while maintaining good relationships with everyone
involved, and the transfer is much more likely to happen if that student has shown high
performance along every step of the way. Consistent transparency and high performance are
characteristics necessary of a good employee, but especially those just beginning to work in the
field of business coming from the Patterson School of Accountancy at the University of
Mississippi.
Case Study #4: Security Sales

Olivia Duke

Dr. Dickinson and Dr. Cantrell

3 October 2018
Executive Summary – Security Sales

When determining the value of an asset, the company must analyze the credibility of future cash flows compared to the carrying value of the asset in the current period. If there is a decrease in worth that is larger than future cash flows, that is considered an impaired loss. Impairment loss on an asset is difficult to calculate but very important to consider when analyzing a company’s capital on their balance sheets. Other considerations are the classification of the asset and the well-being of the company. Impairment cannot be recovered and deducts value from the company on the balance sheet. Understanding impairment loss and how it affects a company’s assets and overall value is important because it recognizes when an asset no longer has value and requires that company to recognize it on their financial statements.

From this case study, I learned about how different types of assets matter differently depending on the well-being of the company. Impairment loss is an important part of financial reporting, not just internally, but externally as well because everyone from the CFO to external auditors must be aware of impairment on assets such as securities that could alter the worth of the company. Impairment loss analysis must take into consideration the time period, intentions, and capital structure of the company in order to come to the correct conclusion. For example, just because some securities sold created an impairment loss for Generic Bank does not mean that they would have been an impairment loss for another company in different circumstances. Each part of the company plays a role in this determination, and creates a new challenge to pull knowledge from other parts of accounting to form an opinion on the subject.
1. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on the seven securities designated above in 20x2?

Generic Bank will have an impairment loss on the seven specific securities sold at the beginning of 20x3. The loss on the sale of these securities is material, which means that the loss is important no matter what. In addition to this fact, these seven securities were sold at the start of 20x3, which means that the company knew they would be selling these securities, and they company knew they would be sold at a loss, even in 20x2. Since the company planned on selling the securities during the year 20x2, that gives Generic Bank an impairment loss that year even though they were not sold until the beginning of 20x3.

2. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold? If so how would you determine the extent of the impairment?

The other securities besides those seven that were sold will not create an impairment loss for Generic Bank. The bank is keeping those securities, possibly to allow them to gain more value to make up for the loss of selling the other seven. The fact that the bank is does not have the intention of selling the rest of the securities means that they have the potential to experience an increase in value through accumulated interest and fluctuating market rates. The impairment loss is not created because there is still room for growth in the rest of the securities.
3. Does your answer change if you assume the role of Heather Herring, the external auditor? Does your answer change if you assume the role of a bank regulator? What other factors might an external auditor or regulator consider in making their determination?

No matter what the role, the answer would not change. An impairment loss is the same and does not change from any point of view, nor from any specific position whether it be internal or external. While external auditors and bank regulators have very different job descriptions than a CFO does, the fact that the sale of impaired securities was at a loss remains constant across all professions.

4. How would your assessment of the existence of an impairment in both requirements 1 and 2 change if the securities sold had been collectively in a net gain position? What if all the securities sold were in gain positions?

If the securities sold had collectively been in a net gain position, this would mean that the securities overall had created a gain upon sale, but does not guarantee that each security was sold at a gain. Therefore, there is no guarantee that each security was not individually an impairment loss because the situation could hypothetically be that six of the securities were sold at a loss and one was sold at a huge gain that outweighed the other losses. There is a possibility that there are no impairment losses but there is also a possibility that some securities still experience impairment loss that was covered up by the gains on the other sales. On the other hand, if all securities sold were in gain positions then there would be no impairment losses because cash is gained back from each sale. Each security was sold with a gain so there are no losses of any kind, including impairment loss.
Now assume that Generic Bank is adequately capitalized rather than well capitalized. And the bank desires to sell securities to improve capital ratios (through the reduction of risky assets) and to fulfill other borrowing obligations as they come due. Securities may not represent the only assets available to Generic Bank to sell, but access to other forms of borrowing to meet liquidity needs has become more limited.

5. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the other seven securities sold?

   Since Generic Bank is adequately capitalized and trying to improve their standing by getting rid of risky assets, the securities sold would not be impairment losses because the bank is disposing of assets that would continue to lose value if they had been kept. Even if they are sold at a loss, that loss would be better than keeping risky assets if a company is only adequately capitalized. However, the unsold securities would be an impairment loss if they are as risky as the seven sold securities. If those securities are more stable, then it would not be an impairment loss if the bank was allowing them to mature. However, with adequate capital the assets are more likely to experience an impairment loss because there is not as strong of a foundation to maintain risky assets.
Case Study #5: Deep in the Heart of Texas

Olivia Duke

Dr. Dickinson

7 November 2018
Executive Summary – Analysis of Two Cities

I was born in Texas, and lived there my entire life until moving to Oxford to be a student at the University of Mississippi. At the beginning of our third year when we were told to choose the city in which we wanted to begin our careers, it seemed impossible that we would already have to know such a thing. Perhaps that is why I chose Dallas (a), because I have lived there all my life and I know I enjoy living there. My family lives in Dallas and most of my friends will be returning after college as well. With the same logic, I chose Houston (b) as my second choice because it is the city closest to my home. This case study showed me just how much I did not know about my home state, but it also showed me how much I did know about my home and reminded me of the things about Dallas that I hold dear to my heart. I learned the importance of looking into all aspects of the city in which one plans to live, even aspects as simple as where you will do laundry or what entertainment attractions the city has to offer.

Public accounting firms invest so much time and money into the students they recruit each year. In order for those investments to pay themselves off, a new hire should remain at that specific office for at least three years. Although we are young and transferring offices becomes easier the more years a worker puts in, three years is still a substantial amount of time. It is important to do all sorts of research while we are still undergraduate students because even though firms can be accommodating for special circumstances, asking for a transfer simply because one develops a distaste for the city is not acceptable. There are so many different considerations to be made when choosing a place to live, and this case study was great exposure to the steps we will be taking in the very near future when deciding where we want to live and what practice we want to join.
1. What is the population?
   a. In Dallas, the population is 1,341,075 as of 2017. I have lived in this area my entire life, albeit in a suburb of Dallas, but living and working in a city holding over one million people seems exciting, with lots of opportunities to make new connections within the business world as well socially.
   b. Houston’s population is 2,312,717 as of 2017. At almost double the Dallas population, I think I may find Houston’s population too large. There is a big difference between one million and two million, and I am not sure I would be comfortable about such a larger city.

2. Describe the climate and seasonal fluctuations.
   a. Dallas’s average temperatures are 39 to 96 degrees Fahrenheit, with a three-month hot season and a three-month cool season. As a resident of this area, I can understand Texas heat but also know that Dallas can experience some cold winters. I enjoy this area because it is not miserably hot nor miserably cold for extended amounts of time. Dallas experiences all types of weather and climates throughout the year, but none so extreme to cause any fear, which I enjoy.
   b. Houston’s average temperatures are 47 to 95 degrees Fahrenheit. Houston is also very known for its humidity and is close enough to the coast to be a major threat for hurricanes. I am very scared of storms, and living in Mississippi has taught me that I do not fare well with humidity, so I do not believe that I would do well in the muggy Houston climate.
3. Describe the city’s topography, scenery, and other geographic or geologic feature of the area on which the city is located.
   
a. Dallas and its surrounding areas are primarily flat. I see myself as relatively neutral on topography because I am not someone who spends an extended amount of time outdoors. As long as it is easy to get from one place to another, I do not mind the conditions in between.
   
b. Houston is also relatively flat, although it sits on the coastal plain. This means that Houston is more prone to flooding through rainstorms and hurricanes, which I would prefer to avoid.
   
4. What are the individual tax rates within the city?
   
a. Texas does not have an income tax, which means the only taxes I would receive in Dallas are federal and FICA. With an effective federal rate of 8.74 percent and a FICA rate of 7.65 percent, I would pay $8,195 in tax against a $50,000 salary. I would not have to pay a property tax because I will be living at my parents’ house for the first few months and then renting an apartment. I am very excited not to have to pay more taxes due to Texas’s lack of state or local income tax, especially because I will not be paying rent either.
   
b. In Houston, I would pay the same federal and FICA taxes. Although those are the only taxes I would pay, the landlord from whom I would rent would be paying a property tax and factor that into my monthly rent payments. I consider either city ideal for this reason, so that I can save more of my salary from the beginning of my career.
5. What transportation hubs are in the city?
   
   a. Dallas is home to DFW International Airport and Dallas Love Field Airport, both of which serve major airlines with domestic and international flights. Within Dallas, there is the Dallas Area Rapid Transit, or DART, that acts as the city’s public transportation system through busses and light rails. Dallas also has Union Station for trains moving at regular speeds to other connecting cities, such as Fort Worth. Dallas is a hub in and of itself in most aspects, including transportation, which I like because essentially everything I need would be there, but the potential to travel with ease both within and outside of Dallas is always present.
   
   b. Houston also has two commercial airports, George Bush Intercontinental Airport and William P. Hobby Airport. Similar to Dallas’s DART, Houston’s Metropolitan Transit Authority of Harris County, Texas, or METRO, has busses and rails in Houston as well as some of its major suburbs. Houston and Dallas have very similar transportation so I feel very similar in regards to maneuvering the city as well as travel outside it.

6. What is the city’s most prevalent industries?
   
   a. The most prevalent industries in Dallas are defense, financial services, information technology, life sciences, and telecommunications. As a future public accountant, I have a lot to gain from the financial services sector being so large in Dallas.
   
   b. In Houston, the most prevalent industries are oil and gas exploration, petroleum refining, chemical production, and research in both medicine and technology. Where Dallas is strong in financial services, Houston reserves that same power.
for oil and gas. Most firms in Houston dedicate much of their resources to the oil and gas industry, which I think could become tedious. I would much rather learn about the different aspects of financial services.

7. Describe the quality of the city’s healthcare.

   a. Dallas County is home to fifty-one hospitals, including the medical schools of Baylor University and Southwestern University. There are many teaching hospitals and thousands of health care professionals. I have been to many different hospitals and doctors’ offices in the area and I am fully satisfied with the health care in Dallas.

   b. Harris County, where Houston is located, hosts 82 different hospitals and employs over 100,000 health care professionals. As someone who rarely gets sick, but also gets very nervous when symptoms begin to show up, I would feel very comfortable living in an area with such a strong concentration of health care options.

8. What types of crime are common within the city and where are the locations to avoid?

   a. Dallas is not very highly ranked as a safe city, with a crime index of 9. The crime rate is 42.46 percent, with just over 10,000 of those crimes being violent. The most common crimes in Dallas are robbery and assault with over 4,000 cases each. Areas to avoid in Dallas include Oak Cliff and the western and southern parts of the city. This was unsettling to discover, but if I land in Dallas for my career I will be living in one of Dallas’s suburbs, with a much lower crime rate.

   b. Houston is more dangerous than Dallas. It has a crime index of 4 and the crime rate is 55.19 percent. Assaults cases total more than 12,000 and robbery follows
closely with 10,000. Houston has two of the most dangerous neighborhoods in the country, Third Ward and Sunnyside. Unlike Dallas, I would most likely be living inside the city limits, which makes me feel very uneasy as a young woman that would be living alone or with other female roommates.

9. Based on where you see yourself living for the first three years, how much rent do you expect to pay?
   a. In Dallas, I would live with my parents so that I could save up as much money as possible. Living with them, I would not have to pay any rent and could instead put more of my salary towards savings. This is an extremely appealing option because I would love to put away as much money as possible, especially considering that rent is one of the highest expenses for recent college graduates.
   b. In Houston, I would rent an apartment, most likely with friends that I have made while at the University of Mississippi who are also looking to go into public accounting in Houston.

10. What is the typical mode of commuting and likely commute times?
   a. I am lucky enough to have a mom that works in the same area of Dallas where all the firms are, so I will be able to ride to work with her. Average commute time from my house to downtown Dallas is around 45 minutes, which is a little long but goes by quickly when you are not alone in the car.
   b. In Houston, since I will rent an apartment in the city I will most likely use the METRO system to get back and forth from home to work. Highway traffic can get very congested in Houston, so this would be the preferred method of travel. Depending on where my apartment would be in relation to the office, public
transportation would take between 20 and 40 minutes. I actually do not mind public transportation; it could be exciting to find different routes and bus lines that would get me to the same place.

11. Where will you do your grocery shopping?

   a. If I work in Dallas, there is a grocery store down the street from my house where I have grown up shopping. I really love the idea of continuing to shop at my Tom Thumb and the familiarity that comes along with it.

   b. In Houston, I can see myself shopping at the store closest to my apartment. I am not the type of person who hunts for the cheapest price between grocery stores, and so I will find the closest Kroger or Tom Thumb and do the majority of my shopping there. That being said, that mindset may change when I am funding myself completely and I might have to reevaluate and shop at a cheaper store such as Wal-Mart.

12. How will you do your laundry?

   a. In Dallas, I will do my laundry at my house. I love this idea as well because I know with complete certainty that I will always have access to a fully functional washer and dryer for which I do not have to pay.

   b. In Houston, I would try my hardest to find an apartment with its own washer and dryer, or at least a communal laundry floor for the entire building. However, that may be unlikely, and in that case, I would find the nearest functioning and safely located laundromat. As much as I would love to hire a laundry service, I am not confident I would be able to afford one, especially in my first few years of working while also having to pay rent. This prospect is much less comforting than
the washer and dryer in my own house, but I also recognize the excitement of getting out of one’s comfort zone.

13. Name at least three civic, religious, or charitable organizations you would like to be active in for each city.

a. If I work in Dallas, I plan to re-affiliate with many organizations with which I have already been involved. I am currently a member of Ladies Auxiliary of Arlington, which supports local charities such as the Boys & Girls Clubs of Tarrant County. I also would like to become more active in the church in which I grew up, First United Methodist Church of Arlington. Lastly, I would love to join the alumni chapter of my sorority for the Dallas area, as I would be able to maintain the values I held dear throughout my undergraduate years as well as meet similarly minded women. Being able to not only pick up where I left off before coming to Mississippi, but also add on with new things that I came to love while in Mississippi makes me so very excited at the prospect of living in Dallas.

b. In Houston, I would want to join similar groups as those with which I am already active either in Dallas or on campus. I would love to join one of the many Methodist churches in Houston, take part in volunteering for their Boys & Girls Clubs, and join the Houston alumni chapter of my Greek chapter. Having a fresh start in these organizations would allow me to meet people I never would have met if I stayed in Dallas.
14. What are the sports, entertainment, or recreational activities that would you would be most likely to engage in within the city?

a. Dallas itself is home to the NBA Dallas Mavericks and the NHL Dallas Stars at the American Airlines Center. Arlington, the city in which I live, is home to the NFL Dallas Cowboys at AT&T Stadium and the MLB Texas Rangers at Globe Life Park. Not only do teams play in these venues, but they are also stops on nearly every performer’s concert tours. In the fall, Fair Park in Dallas becomes home to the State Fair of Texas with a variety of rides, games, and fried foods, but Arlington is the home to two permanent theme parks, Six Flags Over Texas and Hurricane Harbor. I have attended all of these activities at least once and look forward to frequenting them more often once I am living in the area again.

b. Houston has counterparts to every sports team Dallas has to offer except for hockey. The NBA’s Houston Rockets play in the Toyota Center, NFL’s Houston Texans play in NRG Arena, and MLB’s Houston Astros play in Minute Maid Park. In addition, Houston is renowned for its livestock show and rodeo. Houston is also the home of the Space Center, where visitors can see up close how NASA really works. Houston has the opportunity to provide many activities similar to the ones with which I grew up, giving me the chance to try something new without stepping completely out of my comfort zone.

15. What are the modes of traveling back to your hometown from this city, and what are the average costs you’d incur for each trip back home?

a. If I work in Dallas, I will be in my hometown. Therefore, I would incur no costs of travel, which is a major benefit in my opinion.
b. Travelling to the Dallas area from Houston is very easy. By car, it is only three and a half hours away. There are flights available from Dallas to Houston that are an hour and a half, but if all airport measures such as check in and security are taken into consideration, it is around the same amount of travel time, more expensive, and a lot more trouble than it is worth. I would prefer to drive because I would only have to fill up my gas tank once to get there. There is also a plan in the works for a speed train to be built between Houston and Dallas that would make travel time an hour and a half, going at 205 miles per hour. Houston is the next closest major city to my hometown, which is why I chose to make it my second-choice city. There are plenty of travel options from Houston to Dallas, which give me a multitude of choices for getting home to my family when necessary.
16. Develop a monthly operating budget for Year 2 for each city, with an annual salary of $60,000.

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*tax rates are the effective rates of President Trump’s tax reform

17. Determine whether you still want to live in both cities, and if so, which one is your preferred and why?

Before going into this analysis, Dallas was definitely my preferred city. I have grown up there and know not just the city itself but the entire DFW metroplex very well. Although a Texas native, I must admit that I learned much more about Houston and it is a very appealing city, not to mention a little bit less expensive. I am much more open to the thought of living in Houston after these analyses, but I would still prefer Dallas over Houston as a place to live and work.
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Case Study #6: WorldCom

Olivia Duke

Dr. Dickinson

16 November 2018
Executive Summary – WorldCom

WorldCom is known all over the world as one of the biggest ethical misjudgments to ever occur. The accounting was purposefully altered to make expenses seem smaller than what they really were, therefore highly overstating net income on their financial statements. Throughout this case, I learned the actual entries that created the false information. WorldCom’s leaders knowingly made the incorrect choice of capitalizing the expenses of line costs, which were the payments made to other companies in order to use their service lines for phone calls. Those payments did not meet the criterion for capitalization, but the accountants still capitalized these costs so that they could report huge gains as opposed to huge losses.

This is an important case to study because it not only teaches how to classify costs and expenses, but it also highlights the importance of ethics in the field of accounting. WorldCom ceased to exist shortly after the story broke, and thousands of people lost jobs and money, either through income or investments. It should have been impossible to record these expenses as assets for such a long time without anyone noticing. Nowadays, it would be impossible because of how much regulations have changed as a result of this fiasco. The world of accounting was forever changed because of WorldCom and its financial wrongdoings, and I learned the importance of ethics and correct classification of accounts throughout this case study.
a. FASB Statements of Concepts No. 6 (a replacement for No. 3), Elements of Financial Statements, describes the building blocks with which financial statements are constructed.

i. Explain, in your own terms, how SCON No. 6 defines “asset” and “expense.”

An asset is anything owned by a company that has the potential to provide economic benefits to the company that owns it. Expenses are costs that a company incurs in order to create revenues. Expenses typically are incurred through operations and occur regularly throughout fiscal periods.

ii. In general, when should costs be expensed and when should they be capitalized as assets?

Costs should be capitalized when there is still economic value to be received. In other words, if costs are currently being paid and are creating either potential or actual economic value, then those costs should be capitalized. Once the costs have fully expired, they should be recorded as an expense.

b. What becomes of “costs” after their initial capitalization? Describe, in general terms, how the balance sheet and the income statement are affected by a decision to capitalize a given cost.

When costs are capitalized, they are recorded as an asset as opposed to an expense. That would move those amounts from the income statement to the balance sheet, and lower the total expenses recorded on the income statement. Decreased expenses create a higher net income since a lower amount is deducted from the same amount of revenues.
c. Refer to WorldCom’s statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain in your own words, what these “line costs” are.

In 2001, WorldCom reported $14.739 billion as line costs under operating expenses. The journal entry to record the line cost transactions is as follows, in billions:

Line Cost Expense $14.739

Cash $14.739

Line costs are the expenses incurred by WorldCom to pay local phone companies for use of their service lines. These are considered operating expenses because they are incurred every period and are essential to the functions of WorldCom.

d. Refer to the Wall Street Journal article. Describe the types of costs that were improperly capitalized at WorldCom. Explain, in your own words, what transactions give rise to these costs. Do these costs meet your definition of assets in part a above?

The costs improperly recorded as assets were the line cost expenses described in part c. Since these costs were payments to local phone companies and always ongoing, they could not be capitalized. They were costs incurred to generate revenue, but they could not be capitalized to be an asset because they are ongoing, do not expire, and are a part of everyday operations. The line costs do not meet the definition of an asset because they are not owned by the company and cannot be capitalized to act as an asset because they cannot expire and are continuously ongoing.
e. Prepare a single journal entry (in billions) to record the improperly capitalized line costs of $3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows?

PPE $3.055

Line Cost Expense $3.055

The costs appeared on the balance sheet under property, plant, equipment, or PPE. They appear there because capitalized expenses typically are payments related to PPE. In this case WorldCom capitalized the expenses because they were using the lines as equipment. However, these lines were not an asset belonging to WorldCom. They were still recorded as WorldCom’s assets, and would only appear on the statement of cash flows as PPE depreciates.

f. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.

In these calculations, the assets have been depreciating for 22 years. The depreciated calculated by WorldCom accounts for the line costs that should have been
expensed as opposed to capitalized. The corrected calculations are as follows:

First Quarter: \( \frac{771,000,000}{22 \text{ years}} \times \frac{4}{4} = 35,045,455 \)

Second Quarter: \( \frac{610,000,000}{22 \text{ years}} \times \frac{3}{4} = 20,795,455 \)

Third Quarter: \( \frac{743,000,000}{22 \text{ years}} \times \frac{2}{4} = 16,886,364 \)

Fourth Quarter: \( \frac{931,000,000}{22 \text{ years}} \times \frac{1}{4} = 10,579,546 \)

Total depreciation: \( \$83,306,820 \)

The journal entry to account for the depreciation is as follows:

\[
\begin{align*}
\text{Depreciation Expense} & \quad \$83,306,820 \\
\text{Accumulated Depreciation} & \quad \$83,306,820
\end{align*}
\]

g. Use your answers to parts e and f above, to determine what WorldCom’s net income would have been in 2001 had line-costs not been improperly capitalized. Use 35\% as an approximation of WorldCom’s 2001 marginal income tax rate, in your calculations. State any other assumptions you make. Is the difference in net income material?

<table>
<thead>
<tr>
<th>Reported Income Before Taxes</th>
<th>2,393,000,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corrected Depreciation</td>
<td>86,306,820.00</td>
</tr>
<tr>
<td>Improperly Capitalized Line Costs</td>
<td>(3,055,000,000.00)</td>
</tr>
<tr>
<td>Loss Before Tax</td>
<td>(575,693,180.00)</td>
</tr>
<tr>
<td>Tax Added Back</td>
<td>201,492,613.00</td>
</tr>
<tr>
<td>Minority Interest</td>
<td>35,000,000.00</td>
</tr>
<tr>
<td>Actual Net Loss</td>
<td>(339,200,567.00)</td>
</tr>
</tbody>
</table>

With a loss of multiple millions of dollars, the difference of reported income of over \$1.5 billion as opposed to an actual net loss of \$300 million is definitely considered material. This was major fraud committed by WorldCom and made a huge difference in future cash flows as well as the interests of all stakeholders.
Case Study #7: Starbucks Corporation

Olivia Duke
Dr. Dickinson
6 March 2019
Executive Summary – Starbucks

Having a solid understanding of a company’s financial statements is vital for any stakeholder in any given company. Since accounting is the language of business, it is essential to not only follow along a company’s financial performance, but also to read between the line items to discover what happened to a company in its fiscal year. Starbucks is one of the most universally recognizable brands, and one would never think that they had been in financial trouble around 2012 and 2013. However, after looking over the financial statements and noticing a line item for litigation expense, a stakeholder will realize that the company struggled to turn a profit in those years, and that struggle is reflected in the consolidated statements of earnings and cash flows.

Throughout this case, I learned how to double check not only the financial statements, but also the notes to the financial statements and the opinions of the firm externally auditing the company. Even though Starbucks had operated at a near loss, Deloitte & Touche concluded that the accounting standards and internal controls were both effective and fell in line with PCAOB standards and regulations. Financial statement literacy is important because it allows users to make informed decisions regarding themselves and their relationships to the company or corporation in question. Not being aware of note disclosures or specifically mandated line item expenses could cost the user much time and resources if gone unnoticed.
a. What is the nature of Starbucks’ business? That is, based on what you know about the company and on the accompanying financial statements, how does Starbucks make money?

Starbucks is perhaps the most well-known coffeehouse in the world, with reporting segments in the Americas, Europe/Middle East/Africa, China/Asian Pacific, and Channel Development. The brand recognition that Starbucks carries is a major asset and allows for universal consumer knowledge of Starbucks allows for grocery stores to carry Starbucks’ products worldwide as well as in their own locations. Starbucks makes their money from selling coffee in all different types of locations based on their global reputation and brand recognition. They sell coffee made to order in their stores, but also manufacture coffee to be sold in other coffee shops or grocery stores for consumers to make at home. This makes Starbucks both a wholesaler and a retailer.

b. What financial statements are commonly prepared for external reporting purposes? What titles does Starbucks give these statements? What does “consolidated” mean?

The four most common financial statements are income statement, balance sheet, statement of cash flow, and statement of stockholders’ equity, and Starbucks refers to each of these as Consolidated Statement of Earnings, Consolidated Balance Sheets, Consolidated Statements of Cash Flows, and Consolidated Statement of Equity.

Starbucks’ financial statements are consolidated because they have so many subsidiary companies, and consolidated financial statements include total revenues, expenses, assets, liabilities, etc., from not only Starbucks but also the companies it owns.

c. How often do publicly traded corporations typically prepare financial statements for external reporting purposes?

Publicly traded companies prepare statements for external reporting are required by the SEC every quarter, for a total of four times a year.
d. Who is responsible for the financial statements? Discuss the potential users of the Starbucks financial statements and the type of information they are likely interested in.

A company’s management is responsible for its financial statements, led by the CEO and the CFO. Stakeholders will be users of the financial statements, whether they be internal employee, external shareholders, or those with other interests in the company such as the SEC. Employees want to make sure their employer is financially successful to protect their own job security, shareholders want to ensure a return on their investment, and financial statements are required by the SEC.

e. Who are Starbucks’ external auditors? Describe two “opinion” letters that Starbucks received in 2013. In your own words, what do these opinions mean? Why are both opinions dated several months after Starbucks’ year-end?

Deloitte & Touche in Seattle was Starbucks’ external auditors in 2013, and they wrote two opinion letters, the first stating that the financial statements generated are in compliance with PCAOB standards after performing their own audit on the statements, and the second stating that Starbucks’ internal controls are effective and in compliance with accounting standards and principles. Both of these opinions are unqualified, which is the best opinion an audit client can hope for. Unqualified opinion means that the audit and the internal controls check were both successful and did not need any extra explanations in regards to their financial statements nor their internal controls for financial reporting. They are dated several months after year end because the audit checks the financial statements prepared after year end so there is a grace period to allow for checks on processes, financial statements, and effective internal controls.
f. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total net revenues (sales). Common-size balance sheets are created by dividing each figure on a given year’s balance sheet by that year’s total assets, thereby creating a balance sheet on a “percent of assets” basis. You will use these common-size statements in answering several of the questions below. (Starbucks’ investor relations website—investor.starbucks.com—contains a link to SEC filings. The company’s Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the common-size statements).

### Consolidated Statements Of Earnings (USD $)

<table>
<thead>
<tr>
<th></th>
<th>12 Months Ended</th>
<th>Common Size Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net revenues:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company-operated stores</td>
<td>$11,793.20</td>
<td>$10,534.50</td>
</tr>
<tr>
<td>Licensed stores</td>
<td>1,360.50</td>
<td>1,210.30</td>
</tr>
<tr>
<td>CPG, foodservice and other</td>
<td>1,738.50</td>
<td>1,554.70</td>
</tr>
<tr>
<td><strong>Total net revenues</strong></td>
<td>14,892.20</td>
<td>13,299.50</td>
</tr>
<tr>
<td><strong>Cost of sales including occupancy costs</strong></td>
<td>6,382.30</td>
<td>5,813.30</td>
</tr>
<tr>
<td><strong>Store operating expenses</strong></td>
<td>4,286.10</td>
<td>3,918.10</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>15,469.40</td>
<td>11,512.80</td>
</tr>
<tr>
<td><strong>Gain on sale of properties</strong></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Income from equity investees</strong></td>
<td>251.4</td>
<td>210.7</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>-325.4</td>
<td>1,997.40</td>
</tr>
<tr>
<td><strong>Interest income and other, net</strong></td>
<td>123.6</td>
<td>94.4</td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td>-28.1</td>
<td>-32.7</td>
</tr>
<tr>
<td><strong>Earnings before income taxes</strong></td>
<td>-229.9</td>
<td>2,059.10</td>
</tr>
<tr>
<td><strong>Income taxes</strong></td>
<td>-238.7</td>
<td>674.4</td>
</tr>
<tr>
<td><strong>Net earnings including noncontrolling interests</strong></td>
<td>8.8</td>
<td>1,384.70</td>
</tr>
<tr>
<td><strong>Net earnings attributable to noncontrolling interest</strong></td>
<td>0.5</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Net earnings attributable to Starbucks</strong></td>
<td>$8.30</td>
<td>$1,383.80</td>
</tr>
<tr>
<td><strong>Earnings per share - basic</strong></td>
<td>$0.01</td>
<td>$1.83</td>
</tr>
<tr>
<td><strong>Earnings per share - diluted</strong></td>
<td>$0.01</td>
<td>$1.79</td>
</tr>
<tr>
<td><strong>Weighted average shares outstanding:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>749.3</td>
<td>754.4</td>
</tr>
<tr>
<td>Diluted</td>
<td>762.3</td>
<td>773</td>
</tr>
<tr>
<td>Cash dividends declared per share</td>
<td>$0.89</td>
<td>$0.72</td>
</tr>
</tbody>
</table>
## Consolidated Balance Sheets (USD $)

### In Millions, unless otherwise specified

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$2,575.70</td>
<td>$1,188.60</td>
<td>22% 14%</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>658.1</td>
<td>848.4</td>
<td>6% 10%</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>561.4</td>
<td>485.9</td>
<td>5% 6%</td>
</tr>
<tr>
<td>Inventories</td>
<td>1,111.20</td>
<td>1,241.50</td>
<td>10% 15%</td>
</tr>
<tr>
<td>Prepaid expenses and other current assets</td>
<td>287.7</td>
<td>196.5</td>
<td>2% 2%</td>
</tr>
<tr>
<td>Deferred income taxes, net</td>
<td>277.3</td>
<td>238.7</td>
<td>2% 3%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>5,471.40</td>
<td>4,199.60</td>
<td>48% 51%</td>
</tr>
<tr>
<td><strong>Long-term investments</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>3,200.50</td>
<td>2,658.90</td>
<td>28% 32%</td>
</tr>
<tr>
<td>Deferred income taxes, net</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>185.3</td>
<td>144.7</td>
<td>2% 2%</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>274.8</td>
<td>143.7</td>
<td>2% 2%</td>
</tr>
<tr>
<td>Goodwill</td>
<td>862.9</td>
<td>399.1</td>
<td>7% 5%</td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>11,516.70</td>
<td>8,219.20</td>
<td>100% 100%</td>
</tr>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>491.7</td>
<td>398.1</td>
<td>4% 5%</td>
</tr>
<tr>
<td>Accrued litigation charge</td>
<td>2,784.10</td>
<td>0</td>
<td>24% 0%</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>1,269.30</td>
<td>1,133.80</td>
<td>11% 14%</td>
</tr>
<tr>
<td>Insurance reserves</td>
<td>178.5</td>
<td>167.7</td>
<td>2% 2%</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>653.7</td>
<td>510.2</td>
<td>6% 6%</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>5,377.30</td>
<td>2,209.80</td>
<td>47% 27%</td>
</tr>
<tr>
<td><strong>Long-term debt</strong></td>
<td>1,299.40</td>
<td>549.6</td>
<td>11% 7%</td>
</tr>
<tr>
<td><strong>Other long-term liabilities</strong></td>
<td>357.7</td>
<td>345.3</td>
<td>3% 4%</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>7,034.40</td>
<td>3,104.70</td>
<td>61% 38%</td>
</tr>
<tr>
<td><strong>Shareholders’ equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>282.1</td>
<td>39.4</td>
<td>2% 0%</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,130.30</td>
<td>5,046.20</td>
<td>36% 61%</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>67</td>
<td>22.7</td>
<td>1% 0%</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>4,480.20</td>
<td>5,109</td>
<td>39% 62%</td>
</tr>
<tr>
<td>Noncontrolling interests</td>
<td>2.1</td>
<td>5.5</td>
<td>0% 0%</td>
</tr>
<tr>
<td>Total equity</td>
<td>4,482.30</td>
<td>5,114.50</td>
<td>39% 62%</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES AND EQUITY</strong></td>
<td>$11,516.70</td>
<td>$8,219.20</td>
<td>100% 100%</td>
</tr>
</tbody>
</table>
g. Refer to Starbucks’ balance sheet for fiscal 2013 (the year ended September 29, 2013).
   i. Demonstrate that the accounting equation holds for Starbucks. Recall that the accounting equation is: Assets = Liabilities + Equity.

   Refer to part f.

   ii. What are Starbucks’ major assets? Calculate the proportion of short-term and long-term assets for 2013. Does this seem appropriate for a company such as Starbucks?

   Starbucks’ major assets are cash and cash equivalents, inventories, and property, plant, and equipment. The proportion of short term to long term assets is 48 percent short-term and 52 percent long-term. This seems appropriate because a food service company such as Starbucks would want to have ownership of large amounts of property, plant, and equipment because that would constitute the buildings in which the stores are located as well as the kitchen equipment used to make coffee and food served at Starbucks locations, and short term assets would include the inventories necessary to produce the foods and drinks sold at Starbucks.

   iii. In general, what are intangible assets? What is goodwill? What specific intangible assets might Starbucks have?

   Intangible assets are assets that do not physically exist, but they exclude financing instruments such as bonds and stocks. Goodwill comes from one company buying another and is the difference between purchase price and the acquired company’s net assets. Starbucks is likely to have intangible assets of trademarks, customer data from their app, franchise agreements, and recipes of coffee blends.
How is Starbucks financed? What proportion of total financing comes from non-owners?
Starbucks is financed by a combination of debt and equity, debt coming from liabilities and equity coming from contributed capital. The total debt is $7,034.40 and equity is $4,482.30 (both in millions), and debt to equity ratio is 1.57. This ratio indicates that Starbucks is financed more with borrowed capital than it is with contributed capital, so it is important that Starbucks continues to be successful in order to pay off its creditors.

Refer to Starbucks’ statement of earnings for fiscal 2013 (the year ended September 29, 2013) and to the common-size income statement you developed in part f, above.

Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgements management needs to make in recording sales revenues at Starbucks?

The revenue recognition policies followed by Starbucks include consolidated revenue, company operated stores revenue, licensed stores revenue, CPG/food services/other revenue, and stored value card revenue. For stored value cards, revenue is recognized upon redemption of the gift card in exchange for a Starbucks good, with outstanding gift card balances as well as Starbucks Stars value listed as deferred revenues. Challenges can arise from determining when outstanding balances can be converted to regular revenue in the event a customer forgets they have a gift card or accidentally dispose of it. Although the money has already been received by Starbucks when the gift card was purchased, the performance obligation would be the exchange of money for food or drink, which is not satisfied on outstanding balances.
ii. What are Starbucks’ major expenses?

Starbucks’ major expenses in 2013 were costs of sales at 42 percent of sales and store operating expenses at 29 percent.

iii. Were there any significant changes in the cost structure during the most recent year?

Although there was no major change in any revenues or expenses in the most recent year, there was a major litigation expense recorded at 19 percent of sales that caused an increase in total expenses and therefore a decrease in net earnings.

iv. In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn’t the company just include this amount within the line item for general and administrative expense? Why is it an operating expense?

Litigation expenses must be recorded as a separate line item in order to be compliant with GAAP, and the reasoning must be disclosed in the notes to the financial statements. This is to ensure that all users of financial statements are aware of the well-being of the company from all aspects, not just that of revenues and expenses. It must be reported under operating expenses because it falls under the category of operations even though it is an unusual expense. This specific charge comes from a lawsuit brought about by a former operational partner, Kraft Foods. The amount in question was ordered by an arbitrator in order to settle the dispute between the two companies.

v. Was the company profitable during 2013? During 2012? Explain your definition of “profitable.”

The company was not profitable during 2013 due to the litigation expenses, although profits did make up 10 percent of sales in 2012 when there were no litigation expenses. However, that 10 percent is not attributable to Starbucks so
they did not retain any profit themselves. That being said, Starbucks did not operate at a loss either, and can continue to operate without major problems.

i. Refer to Starbucks’ fiscal 2013 statement of cash flows.

   i. Compare Starbucks’ net earnings to net cash provided by operating activities and explain the difference.

   The net cash provided by operating activities is $2,908.30 and net earnings are $8.30 in 2013 (in millions of dollars). The difference comes from the high litigation expenses incurred in 2013, along with other expenses incurred by Starbucks throughout the year. However, net earnings being significantly lower than net cash provided by operations should be reason for concern for Starbucks and its stakeholders because that means there is a major discrepancy between revenues and expenses, although the litigation expense is known to be an abnormal occurrence. Another expense that could explain this difference is depreciation and amortization expense.

ii. How much cash did Starbucks use for expenditures for property, plant and equipment during fiscal 2013?

   The total asset amount for property, plant, and equipment in 2013 was $3,200.50 (in millions of dollars), and the amount invested based off the statement of cash flows for PPE was net -$1,135.90 between sales of PPE and acquiring new PPE for the company.

iii. What amount of dividends did Starbucks pay during the year? How does this amount compare to the amount of dividends declared as shown in the statement of equity?

   $0.89 * 749.3 million shares outstanding = $666,877,000 dividends declared

   Financing section of cash flow: $628,900,000 dividends paid

   $666,877,000 - $628,900,000 = $37,780,000 dividends owed to shareholders
j. Several notes to the financial statements refer to the use of “estimates.” Which accounts on Starbucks’ balance sheet require estimates? List as many accounts as you can. Are any accounts estimate-free?

Accounts that require estimates are assets, liabilities, revenues, and expenses, and examples are listed in the notes. They include asset and goodwill impairments, stock-based compensations forfeiture rates, allowance for doubtful accounts, depreciation, amortization, warranty expense, future asset retirement obligations, inventory reserves, estimate on stored value cards for revenues, and potential outcomes of future tax consequences. Accounts not on the balance sheet such as dividends, which are declared by the company, are an exact amount and are not estimated.
Case Study #8: BP plc – Contingencies

Olivia Duke

Dr. Dickinson

3 April 2019
Executive Summary – BP Oil Crisis

British Petroleum was responsible for one of the most destructing oil spills of all time, creating widespread chaos and damage in the Gulf of Mexico. From an accounting standpoint, this creates massive problems for the auditor of BP in determining how much contingent liability to record in the financial statements. Contingent liabilities are liabilities that are not guaranteed to happen, but must be recorded if the events necessary to trigger the liabilities are probable and reasonably estimated. In the case of BP, the contingent liabilities were in very high volumes because of the amount of expected litigations resulting from the oil spill. Accounting for contingent liabilities in the wake of an unexpected disaster is very different than accounting for contingent liabilities based on product warranties on defective goods. Liabilities for defective goods on warranty are very reasonably estimated and are very common on the financial statements of most companies that produce some sort of good. Although not impossible, most companies do not place an oil spill and the resulting damages in their contingent liabilities because it is unreasonable to expect for that to happen.

Throughout this case, the importance of expecting the unexpected stood out more than anything. Although BP should not have included an oil spill as a normal contingent liability, it is important to use precedent such as Exxon Valdez to create a basis on which to move forward. BP will be working through the effects of the Deepwater Horizon oil spill for years or even decades to come. Learning to plan for contingent liabilities on a small scale helps to handle larger scale liabilities that tend to rise much more unexpectedly. Recognition of events that could potentially lead to contingent liabilities is equally as important because it could help establish a benchmark on estimating the costs should they arise.
a. What is a contingent liability? Explain, in your own words, when a company would record a contingent liability (i.e. a contingent loss) on its books. List some types of contingent liabilities. Do companies ever record contingent assets (i.e. contingent gains)?

A contingent liability is a liability that may or may not take place in the future, dependent on whether certain events happen. A contingent liability is recorded when it seems reasonable that the events necessary to create the liability will take place and when it is reasonable to estimate the dollar value of the liability. Some examples include product warranties, potential lawsuits, and other pending investigations. Although companies can estimate contingent gains that match up with the other company’s contingent liability, they are never recorded in a company’s financial statements. Only after a contingent asset is realized can it be added to the income statement and balance sheet.

b. Product warranties are a common type of contingent liability. Consider a piece of equipment such as a telescopic joint, which BP purchases from GE Oil and Gas. The telescopic joint compensates for heave and offset on drilling vessels and is sold with a two-year warranty against defects. From BP’s perspective as the purchaser of the telescopic joint, what is a product warranty? From the perspective of GE Oil and Gas, the manufacturer of the telescopic joint, what is a warranty?

From the perspective of BP, the product warranty may be factored into the total purchase price if the cost of the warranty is not already included. However, even if it is probable that the telescopic joint will be defective, the gain from GE Oil and Gas will not be recognized by BP until the products actually become defective and BP realizes the gain. On the other hand, GE Oil and Gas must record their contingent liability on the balance sheet and disclose the estimable loss in the notes to the financial statements during the period of sale even if it does not happen, assuming that the loss is probable and it is reasonable to estimate how much the loss will be.
c. What judgements does management need to make to account for contingent liabilities in general and accrued warranty costs in particular? How does a claim for damages resulting from the Deepwater Horizon oil spill differ from a warranty claim on a piece of equipment such as a telescopic joint?

A company’s management must determine how probable it is that a contingent liability will actually occur, and also a reasonable estimate of the dollar amount of the liability. For example, litigation estimates would result from legal fees plus consultations with a company’s legal team to determine the validity of the claim and the resulting likelihood of a successful lawsuit. For a warranty cost, a reasonable estimate of how much the liability will end up costing is to sample what percentage of product is likely to be defective in any given batch of goods. Warranty claims for both likelihood and cost can be very reasonably estimated.

However, warranty claims resulting from unexpected disasters such as the Deepwater Horizon oil spill are much more difficult to estimate. Oil spills in particular are very far reaching and it takes years to fully assess the damage, making it nearly impossible to create accurate estimates in time for periodic financial statements. Each year following the oil spill, BP can amend their estimates as they receive more concrete information on damages to create a more accurate amount in regards to contingent liabilities.

d. Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. Litigation continues as of early 2011.

An oil spill in the Gulf of Mexico causes extreme issues for any company involved, whether it be BP or any of the entities affected by the spill and its aftermath. BP would have to make estimates on the liabilities that would stem from lawsuits coming from all directions. BP could expect lawsuits from environmental agencies, other boat
owners located in the Gulf of Mexico, fishing companies who lost business due to contamination, residents in the area affected, internal lawsuits from employees and family members affected by the explosion, clean-up workers affected by the aftermath, government fines for not following regulations, and shareholders who could have been misled about the severity of the issue at hand. Estimates will have to be made based on legal fees, valuation of assets, measurements of profits lost, and compensatory and punitive damages.

As an auditor, it would be quite difficult to estimate the true amount of losses because an oil spill to this magnitude will have long lasting ramifications. The main problem that BP’s auditors and lawyers would face is determining the point at which to draw the line to determine a baseline for accrued contingent liabilities. As stated above, Exxon’s 1989 oil spill was facing law issues over twenty years later. The best way to establish a starting point is to consult with attorneys on precedent, specifically the Exxon Valdez spill. That case can be used as a benchmark to run analyses on how much BP can expect to pay out in lawsuits and liabilities.

Boundaries must be drawn when making these estimates, otherwise the auditor could speculate forever on how many entities were truly impacted by the oil spill and its aftermath. A possible boundary line would be who comes forward within the period of the spill happening. Although some companies will not experience the adverse effects of the oil spill until later, the accrual of contingent liabilities will be adjusted periodically to reflect the increase of people seeking payback and damages for their own losses.
Case Study #9: The Wendy’s Company – Equity Investment Methods

Olivia Duke
Dr. Dickinson
10 April 2019
Executive Summary – Equity Method

Many companies, such as Wendy’s, employ joint ventures when searching for ways to move further into the market. Joint ventures present shared risk and reward between the parties involved, which allows firms to take the risks necessary to expand without as much concern for what the outcome might be. Since joint ventures are owned 50% by each party, they can exert significant influence over the venture as a whole and must account for the activities of the venture using the equity method. The equity method recognizes the amount of initial investment in the investee, but also recognizes income or operating losses as an adjustment to the investment account. In other words, the investor has enough ownership to experience income or losses to a degree in which they must be accounted for on the investor’s own financial statements. This case examines the technicalities of equity method accounting and reporting using the example of Wendy’s joint ventures.

This case shows how financial reporting can differ if a company were to elect to use the fair value method when the equity method is necessary. The equity method provides financial statement users with a better idea of the standing not only for the investor, but the investee as well. When the investee is performing poorly and the investor has significant ownership and influence, it will greatly impact the investor’s financial statement and must be disclosed. Joint ventures provide a unique opportunity for companies to explore and expand into new areas of the market with less risk, but also must be accounted for with the equity method because joint ventures are essentially new companies formed solely by two owners.
a. In general, why do companies enter into joint-venture agreements?

In a joint venture, two companies create a separate entity with a specific goal in mind. The originating companies are given the ability to take business risks with less of their own assets at stake. By going into a joint venture, the companies in the agreement will not only share the profits, but also the risks. Joint ventures can allow companies to enter into new segments of the market that an individual may not have been able to reach on its own because that company can pair up with a strong contender in the market in question. The main attraction of a joint venture agreement is that both the risk and the reward are shared between the parties of the agreement.

b. Consistent with U.S. GAAP, Wendy’s uses the equity method to account for its joint venture in TimWen. Briefly explain this accounting method. In your answer, be sure to comment on how the investing company accounts for its initial investment and any subsequent income and dividend activity of its investee.

The equity method of accounting is used when an entity owns a large portion of another company’s shares and can exert significant influence with those shares. This is a step above the fair value method of accounting for owning shares, in which they are reported at current fair value. The equity method is the recording of shares at the cost at which they were purchased, and demonstrates the gains and losses experienced by the owners of the shares as a result of the equity investment. Income and dividends are essentially reported as adjustments to the first record of equity investment, instead of the fair value method’s version of recording dividends as cash payments.
c. When a company purchases shares (ownership) in another company, the investment account may exceed their share of the book value of the underlying net assets of the investee. How does the investing company account for this excess amount under the equity method?

   When purchasing ownership of another company, the purchasing company is buying the net assets of the acquired company. The net assets are accounted for at fair value. Any time in which the purchaser pays more than the fair value of the net assets, the difference is referred to as goodwill. Goodwill is the extra amount, or acquisition premium, that an entity is willing to pay to acquire the full set of net assets when taking ownership of another firm. Goodwill does not amortize and is reported on the balance sheet as a separate intangible asset, although it can periodically be tested for impairment.

d. Consider the information in Note 8. What amount did Wendy’s include on its 2012 and 2011 balance sheets for their equity method investments? Where does this appear on Wendy’s consolidated balance sheet?

   The equity method investments displayed on the balance sheets are $89,370 and $91,742 for years ending 2012 and 2011, respectively. However, these amounts only reflect the TimWen joint venture. To include the Japan equity investment as well, we must also include the amounts ($1,750) and $77 for 2012 and 2011, respectively.

e. Using information in Note 8, compare the amount recorded for Wendy’s investment in TimWen at December 30, 2012 with Wendy’s 50% share of TimWen’s equity at December 30, 2012. What accounts for the difference between these two amounts?

   Wendy’s investment in TimWen is half of the partners’ equity, as a joint venture between Wendy’s and Tim Horton. Therefore, Wendy’s share of the TimWen net assets is $70,565 * 50% = $35,283. The total equity investment with the Tim Hortorn joint venture was $89,370. This creates a difference of $54,087. That difference is known as the accounting acquisition premium, and contains the goodwill of the purchase as well as the write up to fair value amounts. Goodwill is not amortized, although it is checked
annually for impairment. This amount stems from purchase price adjustments from the original merger of Wendy’s and Tim Horton’s and represents how much the investment exceeded the actual interest of the joint venture.

f. Consider the information disclosed in Note 8 regarding Wendy’s investment in the TimWen Joint Venture.
   
i. How did Wendy’s equity method investment in TimWen affect their earnings before taxes in 2012 and 2011? Where does this appear in Wendy’s consolidated statements of operations?

   In both years, the earnings from equity investments have to be amortized to account for purchase price adjustments. In 2012, equity earnings were $13,680, but the purchase price adjustment of ($3,129) has to be deducted to total $10,551 of earnings before tax. Applying the same treatment for 2011, $13,505 less $2,934 equals $10,571 earnings before tax from equity investments. These amounts are reported as part of other operating expense, net.

   ii. Prepare the journal entry to record Wendy’s share of TimWen’s 2012 earnings.

   2012  
   Equity Investment  13,680  
   Equity Income      13,680

   iii. What is the amount of the amortization of the purchase price adjustments in 2012? Prepare the journal entry to record the amortization of the purchase price adjustments for 2012.

   2012  
   Equity Loss        3,129  
   Equity Investment  3,129

   iv. What amount of dividends did Wendy’s receive from the TimWen joint venture in 2012 and 2011? Prepare the journal entry to record the receipt of dividends from TimWen for 2012.

   2012  
   Cash              15,274  
   Equity Investment 15,274
g. Consider the information in the statement of cash flows.

i. The operating activities section of the statement of cash flows reports a negative adjustment for “Equity in earnings in joint ventures, net” of $8,724 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a negative adjustment is made to arrive at cash from operating activities.

The earnings before tax for 2012, $10,551 do not include the loss from the Japan venture of $1,827. Therefore, the net earnings from joint ventures of Wendy’s would be $10,551 – $1,827 = $8,724. The adjustment in cash flows is negative because $10,551 and ($1,827) amounts are both reported in Note 8, but the net earnings must be reconciled in the statement of cash flows and are deducted because it is a non-cash activity initially recognized in net income. Normally equity activities are listed under the equity section of the statement of cash flows, but since the joint venture is 50 percent owned by Wendy’s, it becomes an operational activity.

ii. The operating section also reports a positive adjustment from “Distributions received from joint venture” of $15,724 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a positive adjustment is made to arrive at net cash from operating activities.

The amount of $15,274 is reported at distributions received in 2012, otherwise known as dividends. Dividends received is the only transaction through TimWen’s equity method that goes directly to cash for Wendy’s as a partner in the joint venture. Since these dividends are not listed in the consolidated statement of operations, the amount is added to the total operating activities since they were realized as cash.
Case Study #10: Johnson & Johnson – Pension Accounting

Olivia Duke
Dr. Dickinson
19 April 2019
Executive Summary – Accounting for Pensions

One of the many benefits of being in the American work force is the guarantee that most companies provide pension benefits so that their employees will be able to enjoy a comfortable retirement. With companies the size of Johnson & Johnson, it is important to begin planning for employees’ retirement essentially at the moment they are hired, in order to make sure there will be benefits available upon retirement. Johnson & Johnson offers both defined-contribution plans, in which there is a fixed periodic payment into a retirement account, and defined-benefit plans, in which there is a set benefit that will be available upon retirement, and it is up to the employer as to how that amount will be reached. Companies use actuaries to help estimate how much funding their retirement plans will require, based on assumptions of life span, years left to work, and salary level changes. For defined-benefit plans, it is important to keep track of payments periodically to ensure employees will be compensated in the future.

Throughout this case, I learned the importance of planning ahead of time for retirement benefits. Maintaining actuarial assumptions as well as all other components of pension accounting is not only important to the company for financial purposes, but it is also important to the employees because it will be their means of living up once they reach the age of retirement. Since Johnson & Johnson releases this annual report, any employee could see the status of the retirement plans at any point, and it is likely that employees could be upset upon seeing the status of the pension obligation account being underfunded. In 2007, Johnson & Johnson needed to implement some changes to their pension fund in order to accommodate the amounts owed to current and future retirees.
a. There are two types of retirement (i.e. pension) plans – defined benefit plans and defined contribution plans.

i. How do these two types of plans differ? Which type does Johnson & Johnson have?

The two types of pension plans are defined-contribution plans and defined-benefit plans. Defined-contribution plans are plans in which the employer puts a fixed amount into the retirement fund each period, based on a formula created by an actuary. Defined-benefit plans also require periodic funding, but differ from defined-contribution because defined-benefit plans do not have set payments, but instead a set ending amount that employees will receive upon retirement. According to Note 13 to the financial statements, Johnson & Johnson “sponsors various retirement and pension plans, including defined benefit, defined contribution and termination indemnity plans.”

ii. Explain why retirement obligations are liabilities.

Retirement obligations are liabilities because they are amounts owed and amounts that will be owed to current and former employees. Employees are guaranteed retirement benefits from their employers and therefore those payables are considered a liability by the company until they are paid out to their retirees.

iii. List some of the assumptions that are necessary in order to account for retirement plan obligations.

Actuarial assumptions play a major role in pension accounting because they estimate the expenses the company will incur. The circumstances of retirement vary between each employee a company has. Common assumptions that actuaries make in order to facilitate pension accounting is retirement age,
future salary, average life span after retirement, and estimated time an employee will work at a company.

b. In general, companies’ pension obligations are influenced each year by four main types of activities: service cost, interest cost, actuarial gains or losses, and benefits paid to retirees. Explain each of the four activities in your own words.

Service cost is the amount of expense that comes from employees working another year, thereby increasing the amount of retirement they will be owed in the future. Interest cost is the interest that comes from the obligation itself, since the time value of money is involved throughout the years of employees working and retiring. Actuarial gains and losses refer to the fact that actuarial assumptions are not concrete and are subject to change at any point. Because of this, gains and losses can occur as the actuarial assumptions change the estimates previously made. Once benefits are actually paid out to current retirees, it will lower the obligation by the amount paid because that part of the obligation is considered to be satisfied.

c. In general, companies’ pension assets are influenced each year by three main types of activities: actual return on pension investments, company contributions to the plan, and benefits paid to retirees. Explain each of the three items in your own words.

The actual return on plan assets refers to the minimum risk stocks and bonds that provide return to be used for pension benefits. The actual return on pension plan assets is the difference between ending and beginning balances for the year once contributions to the plan assets and benefits paid out are taken into consideration. Company contributions are the actual cash payments a company makes into the pension plan each year to ensure that future benefits will be sufficient for their retirees. The benefits paid to retirees decrease the amount of plan assets because the money comes out of the plan assets in order to go to the retirees.
d. In general, companies’ pension expense and pension plan assets both have a “return on plan assets” component. How do the two returns differ? Explain the rationale for this difference.

Pension expense and pension plan assets both include return on plan assets. Expected return on plan assets is typically what is included in the pension expense calculation because it can reduce market-induced volatility in the income statement. Then, a separate calculation is made once actual return on plan assets is known. That calculation allows for the acknowledgement of unexpected gain or loss on return of plan asset depending on what actually happens throughout the period. That unexpected gain or loss is reported under Other Comprehensive Income as well. For pension plan assets, the actual return on plan assets is used in reporting.

e. Johnson & Johnson provides other benefit to retirees including health-care and insurance benefits. What is the primary difference between the company’s other-benefits and its retirement plans?

The primary difference between Johnson & Johnson’s other-benefits and retirement benefits are that the other-benefits, most of which are health care related, are available to retired employees in the U.S. and their dependents, while the retirement benefits are available to domestic and international employees alike. The international retirees receive health care benefits from government programs instead of Johnson & Johnson.
f. Consider Johnson & Johnson’s pension expense detailed on page 61 of the company’s annual report. Note that the company uses the term “net periodic benefit cost” to refer to pension expense.
   i. How much pension expense did Johnson & Johnson report on its 2007 income statement?

   In 2007, Johnson & Johnson reported $646 million.

   ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense.

   
   
   12/31/07 Service Cost 597
   Interest Cost 656
   Project Benefit Obligation 1,253

   g. Consider Johnson & Johnson’s retirement plan obligation, that is, the pension liability, as detailed on page 62 of the company’s annual report.
   i. What is the value at December 31, 2007, of the company’s retirement plan obligation? What does this value represent? How reliable is this number?

   The value of the company’s projected benefit obligation is $11,660 million, which represents the amount owed to employees either currently retired or who will be retiring in the future. This number is based partially upon actuarial assumptions, which means there could be some changes in the future, but is for the most part quite reliable.

   ii. What is the pension-related interest cost for the year? Compute the average interest rate the company must have used to calculate interest cost during 2007. Does this rate seem reasonable? Explain.

   The pension related interest cost for the year was $656 million. Working backwards, the interest rate that Johnson & Johnson would have used is 5.6 percent, which is reached by dividing $11,660 million by $656 million. According to the Pension Benefit Guarantee Corporation, the standard rate for interest on pensions at the end of 2007 was 5.42 percent, so this rate seems reasonable.
iii. What amount of pension benefits were paid to retirees during the year? Did Johnson & Johnson pay cash for these benefits? How do the benefits paid affect the retirement plan obligation and retirement plan assets?

The amount paid to retirees during the year was $481 million. The benefits were paid out of plan assets rather than cash, and decreased both retirement plan obligation as it met the obligation previously guaranteed to employees and the retirement plan assets since it was used to pay the benefits.

h. Consider Johnson & Johnson’s retirement plan assets, that is, the pension plan asset, as detailed on page 62 of the company’s annual report.
   i. What is the value at December 31, 2007, of the retirement plan assets held by Johnson & Johnson’s retirement plan? What “value” is this?

At the end of 2007, the value of the retirement plan assets was $10,469 million, measured at fair value.

ii. Compare the amount of the expected return on plan assets to the amount of the actual return during 2006 and 2007. Are these differences significant? In your opinion, which return better reflects the economics of the company’s pension expense?

The amount of expected returns in 2006 and 2007, respectively, were $701 million and $809 million, according to page 61 of the annual report. However, the actual returns were $966 million in 2006 and $743 million in 2007, according to page 62. The actual return on plan assets in 2006 was 27.43 percent higher than the actual return, which is quite significant. In 2007, the actual returns were only 8.17 percent higher than expected, which is immaterial for a company the size of Johnson & Johnson. It seems probable that the actuaries working with Johnson & Johnson used the large difference in 2006 to better account for 2007. Because of this, I think it is better to use expected return because it allows other estimates to
be made and even if the expected number is incorrect, it can be fixed at a later date.

iii. How much did Johnson & Johnson and their employees contribute to the retirement plan during 2007? How does that compare to contributions in 2006?

   In 2007, Johnson & Johnson contributed $317 million and employees contributed $62 million for a total of $379 million. In 2006, Johnson & Johnson contributed $259 million and employees contributed $47 million, totaling $306 million. There was an increase of $11 million in contributions between 2006 and 2007.

iv. What types of investments are in Johnson & Johnson’s retirement plan assets?

   The types of investments in retirement plan assets are both equity and debt for U.S. retirement plans, with 79 percent of the assets being equity securities and the other 21 percent being debit securities. International retirement plan assets are 67 percent equity securities, 32 percent debt securities, and 1 percent real estate and other types of assets.

i. Is the company’s retirement plan under funded or over funded at December 31, 2007? At December 31, 2006? Where does this funded status appear on the company’s balance sheet?

   On December 31, 2007, the retirement plan was underfunded by $1,533 million. Likewise, on December 31, 2006, the retirement plan was underfunded by $2,122 million. These specific amounts can be found on page 62 of Johnson & Johnson’s annual report, but the amount itself is allocated on the balance sheet into non-current assets, current liabilities, and non-current liabilities.
Above is a flow chart describing the pension funding process from start to finish, with Reynolds Co. as the employer, Jones Albritton as the employee, and Adam Weekley as the pension funding agency.
Case Study #11: Balance Sheet vs Income Statement Approaches

Olivia Duke
Dr. Dickinson
28 April 2019
Executive Summary – Compare and Contrast of Approaches

The FASB currently has the standard of balance sheet reporting. This means that the accounts listed on the balance sheets are those that are taken into consideration when a company is audited. However, FASB is reconsidering this approach and its fit in the conceptual framework. Many feel that the income statement approach to financial reporting more accurately reflects the goals of a company, because the balance sheet approach has major limitations due to the valuation standards of assets, liabilities, and stockholders’ equity. The income statement approach is supported because it does a better job of recognizing revenue and properly matching expenses to those revenues. The previous solution has been to enforce a separate income statement in the financial reports while still following the balance sheet method, but experts are now saying that this is not an adequate statement of a company’s performance or well-being.

In the late 1970’s, it was determined that the balance sheet approach was the most logical method of financial reporting. It has since been accepted worldwide, even being implemented as the International Accounting Standards Committee (IASC) framework. The spread of balance sheet reporting to the international stage will make it even more difficult to change the framework, but it does not change the fact that many people are calling for income statement reporting. The author lists four main reasons that the balance sheet approach no longer best suits the field of accounting. The first reason is that is does not adequately describe how most companies “operate, create value, and are managed.” Most companies use assets to serve the goal of creating profit, and the balance sheet paints assets as important and having value independently of the goods or services made by the company. Expenses are incurred by way of using assets to create revenues, and the financial reports would better reflect the value of the companies that operate in this manner. The second reason is that, although the FASB alleges that
the balance sheet approach is superior, but the income statement seems to be the better approach for a number of reasons. Income has a much clearer definition as to how it pertains to the success of a company and provides a trail to follow to measure how and when a company makes its money. Because of items like intangible assets, it is much harder to track what a company makes based solely off the assets it owns. The third reason is that balance sheet accounting handles earnings differently than the income statement does because it views any increase in earnings as “change in net assets” which creates higher earnings volatility and provides less information about future earnings potential. The fourth and final reason is that in the real world, there are problems when applying the model because it is sometimes extremely difficult to estimate market values. These critiques of the balance sheet approach are all major reasons that the FASB should consider moving towards the more accurate and understandable income statement approach.

Throughout reading this article, I learned that accounting is not as straightforward as it may seem. Although the amounts on financial statements have to match each other throughout, there are still many issues on the best way to handle reporting. The FASB is considering an attempt to alter the conceptual framework, which would have global ramifications. I had never considered the types of consequences a change in reporting approach could create. The balance sheet approach is the global standard, but there are many reasons to change the standard to the income statement approach because it is a better way to understand a company’s financial standings and will also be a better choice for the economy as a whole, since it affects how companies will measure their future potential earnings and therefore how a company makes decisions for future business endeavors.
Analysis

This article has changed the way I view accounting because it made me realize that although companies must follow GAAP and the guidelines it sets as standard, there is still much debate about the way financial statements should be presented. The income statement approach seems to be the best alternative because although the FASB centers its entire conceptual framework around the concept of an asset, the revenues and expenses seem to better describe how companies operate and generate profits. I had never spent much time considering how different it is for a company to report using the balance sheet approach as opposed to using the income statement approach.

Upon reading the title of the article, I had not realized there were different approaches because GAAP financial statements include both a balance sheet and an income statement. Before reading, I would have said that the balance sheet would be a good indicator of a company’s standing because it lays out clearly what a company owns and what it owes to other entities, and the difference between those amounts. However, as the article stated, the ability to analyze earnings is becoming increasingly more important. This analysis cannot be done on the balance sheet alone because it does not list revenues nor expenses. Although retained earnings are listed on the balance sheet, it is much more clear and understandable to analyze the income statement. Furthermore, the balance sheet lists out assets, liabilities, and equities in a hope to describe the company fully, but this is almost never the case. For example, property plant and equipment typically has a high value and allows for a high dollar amount to go into total assets. However, most property plant and equipment assets incur expenses while being used to generate revenues. Independently of the company’s operations, the PPE would not be bringing value to the company. This could be interpreted as assets being inflated to a number higher than what
worth the company actually has, because the PPE does not have worth for the company independent of the company’s operations.

Examples like this have changed my mindset because I have learned the reality of financial reporting in the sense that there are so many ways in interpret the same set of numbers. That is why it is important for the FASB to make a clear decision for the conceptual framework. That being said, changing the framework is not a small matter, and will take years to fully implement and begin change around the world. The article changed my belief in that I now think that the income statement approach is most likely worth all of the adjustments that would have to be made in order to implement a new reporting system. The income statement approach allows for a clearer understanding of a company’s operations, which is necessary for all stakeholders both internal and external. Although it would take an extended amount of time to fully change the standard, the changes are being called for by many accounting and economics experts and makes the most sense. Just as tax laws change to adapt to the financial environment, so should accounting guidelines to match the way companies operate. My current way of thinking has changed because not only do I now recognize the importance of distinguishing between the balance sheet approach and the income statement approach, but I also see that the income statement is the way that best fits today’s economic, financial, and accounting environment.

With the information I have gained from this article, there are many things to consider when thinking about my potential future career paths. In the world of accounting, there is a possibility that I will see the official change from the balance sheet approach to the income statement approach while I am a working professional. If this is the case, I will have to make sure I am able to adapt quickly and know the expected changes that will come as a result of the new standard. Accounting professionals must always be prepared for changes in methods or
principles because accounting treatments are always subject to change, but a change of this magnitude would have more consequences than a normal one. All companies would have to learn entirely new reporting methods, and learn how to analyze the new reports.

Another use for this information would be a potential career in academics. As a student during the time of the Tax Cuts and Jobs Act, I have witnessed many professors learning the material as they are teaching it to us. Accounting is one continuous cycle of learning, and there is always something new to master. As an academic, there is potential to not only be able to teach young accounting students the new rules as they are implemented but also to be able to research the potential results of such a change before it happens. A researcher could work either independently or with the FASB to help identify the best ways to create an income statement approach solution. An academic would have the specific expertise to help create the new standard as well as teach others the new standards once they have been put into place.

Possessing knowledge on both the income statement approach and balance sheet approach of financial reporting will also be attractive to the private industry sector. Many accountants leave the public accounting career in order to pursue a more specified career path in a certain industry, and knowing the details of both kinds of financial reporting would certainly be attractive to potential employers as a source of information once the changes begin to take place. Having an internal employee that knows what to expect in both situations would be much easier than hiring an outside consultant because an internal employee is accessible for that company at all times to help answer any questions.

In general, having a wealth of knowledge on the subject of income statement reporting and balance sheet reporting of financial statements is going to be very desirable both now and in the years to come, especially when the FASB changes their method. Although this discussion is
currently hypothetical, I believe it will be put into effect in some degree while I am an accounting professional. There are too many points to be made for income statement accounting, such as ease in understanding and creating better analyses for the economic environment.

Earnings are the most important part of understanding a company’s performance, and that is better learned from the income statement approach than the balance sheet. In addition, having the knowledge of both approaches and their impacts will be extremely useful as we as a generation of students enter the professional world.
Case Study #12: Google Inc. – Earnings Announcements and Information Environment

Olivia Duke
Dr. Dickinson
3 May 2019
Executive Summary – Google

The FASB has created Generally Accepted Accounting Principles, or GAAP, as a standard for reporting entities to inform stakeholders on financial performance in the same manner. Every company reports their financial performance using GAAP, but many elect to also use non-GAAP performance measures if the company feels that they better reflect its status. Google utilizes non-GAAP financial measures in order to show their financial statement users a more concrete idea of what part of their revenues come from operations, along with reconciliations with how these numbers match up to their GAAP counterparts. Google’s revenues using both GAAP and non-GAAP standards showed huge increases, however the non-GAAP numbers were significantly higher. Google’s stock price increased in correspondence with the increased revenue, which had a positive impact on the market and a positive reaction from investors.

From this case, I learned the importance of the financial statement reporting methods. The utilization of both GAAP and non-GAAP measures side by side allows for users to analyze performance from multiple perspectives. Non-GAAP measures such as adjusted EBITDA show readers the status of a company’s earnings before necessary expenses such as interest, tax, depreciation, and amortization. EBITDA is preferred by many companies because it creates a higher amount of earnings, but is criticized for the same reason. Reading about the specifics of non-GAAP performance measures and the roles they play on a company’s financial statements and public press releases has taught me the importance of a good foundation of accounting knowledge because a company can take steps to make its performance indicators look as well off as possible in order to please investors. The role of accountants and analysts is to determine the
validity of the non-GAAP performance measures and find the truth that could lie in GAAP, non-GAAP, or anywhere in between.

a. Read the excerpts of the press release titled “Google Announces Fourth Quarter and Fiscal Year 2013 Results” and review Google’s operating performance reported in the statements of income accompanying the press release. The press release includes information about non-GAAP financial measures for the fourth quarter of 2013. Consider the table that reconciles GAAP measures to the non-GAAP measures. What explains the difference between GAAP net income and the non-GAAP equivalent? Do you agree with each of Google’s adjustments in computing non-GAAP earnings? Why or why not?

According to the article by Afterman on the use of non-GAAP performance measures, many companies use them in addition to the required GAAP financial measures. These measures have been used since the 1960s, especially in regards to earnings. Non-GAAP earnings are used because indicators such as EBITDA allow the reader to see how much money is made through operations before necessary expenses are incurred. The SEC has led the rest of the world in regards to how a company may present non-GAAP financial measures in the sense that the reporting must be made in segments within a company. Although many companies elect to employ non-GAAP performance measures in addition to those required by GAAP, there are many critics of utilizing measures outside of those required from every company because they show “income before the bad stuff.” Criticisms have lessened since Regulation G required companies to reconcile their non-GAAP measures to their corresponding GAAP counterparts, as can be seen in Google’s financial statements. Another solution to help prevent artificially inflated non-GAAP income amounts is the adjusted EBITDA, which includes adjustments for stock compensation, write-offs, merger costs, restructuring costs, loss on debt extinguishment, fair value changes, and gains and losses on asset sales. Some companies prefer to use the terms “core earnings” and “underlying profits,” in order to
avoid the connotation that has become attached to EBITDA. In regards to Google, the
difference between GAAP and non-GAAP income from operations comes from actual
income as opposed to the income multiplied by the operating margin after adjusting for
stock compensation, restructuring charges, elimination of income tax effects, and
elimination of net loss from discontinued operations. I agree with Google’s adjustments
because I can follow their reconciliation step by step and can see where the company
found the differences between GAAP and non-GAAP income measures.

b. Use the attached stock-market charts for Google for the period January 1, 2013 through
February 14, 2014, to answer the following questions.

i) Compare Google’s fiscal 2013 earnings performance with the movement in
Google’s stock price over 2013.

Google’s 2013 fiscal earnings performance showed a tremendous increase
throughout the year, especially in the last quarter. Google’s stock price reflected
the sharp increase in revenue, as can be seen in the given stock charts. There were
small dips in stock price but an overall increase in price corresponding to
Google’s revenue growth.

ii) Compare Google’s 2013 stock price performance with the performance of the
broader set of firms trading on the NASDAQ exchange (that is, the NASDAQ
index).

As stated above, Google’s revenue growth allowed for a tremendous
increase in stock price exchange. In fact, the increase in Google’s stock price was
so high that it went above the NASDAQ index for almost all of 2013, but
especially in the last quarter.
Based on the stock market chart, did the market perceive the earnings news in Google’s press release dated January 30, 214 as “good news” or “bad news”?

The market would have perceived the earnings as good news because the stock price was consistently above the NASDAQ index. The market will want to see companies’ successes and high revenues because that means the economy overall is succeeding, which is reflected by the stock price rising above the NASDAQ index.

c. Read the Wall Street Journal article from January 20, 2014 titled “Google Reports Higher Profit.”
   i) According to the article, how did Google’s fourth quarter revenue and earnings compare to the consensus analyst forecasts at the time of the earnings press release? Are these relations consistent with the positive stock market reaction following the press release?

The fourth quarter revenues and earnings from Google were slightly lower than what analysts had forecasted, but the article states that investors “shrugged off” these results. Revenue was higher than the analysts had predicted. While the bottom line results were not what analysts had hoped for, the overall effect of Google’s fourth quarter outweighed these incorrect forecasts and investors’ reactions were consistent with the positive stock market reaction.
ii) What other factors does the article discuss that might contribute to the market’s positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Google’s recent performance?

The market would have had a positive reaction to any company with such high revenues, but especially Google because in 2014, smart phones were becoming more and more popular. There was an industry fear that websites such as Google would lose market share because consumers were now using phones more than they were actual computers. The tremendous revenue growth would have soothed these fears and helped Google maintain its position as a media and technology giant.